Based on the Commission's overall consideration of the policy goals and requirements set forth in Section 13-506.1 and the whole of the evidence in this proceeding, we find that the Plan constitutes a more appropriate form of regulation which can and will be modified to serve the public interest. Hence, we move forward.

IV. RATE RE-BALANCING

AI's Position

In its rate re-balancing proposal, AI proposes to increase the monthly charge for residence network access lines by $2 per month across all access areas, while reducing other service rates to make the plan revenue neutral. The new residence access line charges, including the end user common line ~~charge ("EUCL"),~~("EUCL") charge, would be $8.90 in access area A, $11.88 in access area B and $15.35 in access area C. AI asserts that there has been no increase in network access line rates since 1990. Even with the proposed $2 increase in effect, the network access lines will have increased less than the inflation rate. Thus, AI asserts, even after the increase, the real costs of residence access lines would be lower than it was in 1990. AI projects the total revenue increase resulting from the residence network access line increase would equal $84.1 million.

AI asserts that it has requested the increases to bring rates more into line with costs and to narrow the difference between residence and business access line prices. At current rates, AI claims its residence access lines are priced below LRSIC in access area B and C. Although current rates cover LRSIC in access area A, AI asserts that when shared costs and non–recurring costs are included, that rate is also below cost.

Moreover, AI asserts that LRSIC, as calculated under the Commission's Cost of Service Rule (the "Rule"), 83 Ill. Admin. Code Part 791, understates the incremental costs of network access lines. Section 791.70(d) requires that LRSIC be calculated based upon the assumption that the entire useable capacity of network facilities is used to provide service. "Usable Capacity" is the maximum physical capacity, less capacity required for maintenance, testing or administration. 791.20(n). In the real world, facilities are almost never operated at their usable capacity for a variety of ~~necessary~~ reasons. ~~Therefore,~~As such, more facilities are required to meet the demand for residence access lines than are included in the cost study. The "spare capacity" costs for these necessary, additional facilities are treated as common costs to be recovered from all services when, in reality, they should be considered part of the LRSIC costs of access lines. Spare capacity costs for residence network access lines are shown in AI Ex. 10.1, Schedule 9 (rev.) and are significant. If spare capacity costs were included, the LRSIC of access lines, on average, would increase by 80.2%.

When LRSICs (as computed under the Rule) are considered in conjunction with shared, non-recurring and spare capacity costs, access line prices are significantly below costs in all access areas, even if those services are not asked to contribute to the recovery of common costs. However, the Commission has recognized that individual services should make a reasonable contribution toward recovery of common costs in both the TELRIC proceedings and Phase II of Access Charge reform proceedings. Similarly, the FCC required LECs nationwide to develop forward-looking economic costs of service ("FLECs") that included an allocation of common overheads. These costs will be used by the FCC to determine eligibility for federal high cost funds. The Commission approved AI's FLEC methodology in Docket 97-0515.

In AI's opinion the under-pricing of access lines has adverse consequences for both customers and competitors. Competitors have shared costs and spare capacity costs too. When residence access lines are priced so low that they do not recover costs, or at least a substantial portion of them, AI claims its competitors are deterred from offering residence access line services which in turn result in a lack of infrastructure investment. For consumers, AI claims low prices stimulate inefficient and excessive demand, ~~which~~and the Company is reluctant to build new facilities to satisfy because the service is unprofitable. Consequently, AI believes efficient consumption of services such as usage and vertical features is discouraged because these services must be priced too high in relation to their costs in order to make up for the shortfall in residence access line revenues.

To offset the increase in rates for residence network access lines, AI proposes to reduce one-time residence service ordering and installation charges by $21.6 million. Further, AI is offering to reduce Band B additional minute charges by approximately 12.7 million based upon the Company's perception that consumer would like to see the Band B rate structure move in the direction of the Band A per call rate structure. AI also proposes to reduce pay per use charges for three calling features: automatic callback, repeat dialing and three way calling, by about $5.1 million. Finally, AI has already reduced carrier access charges by $33.3 million pursuant to Commission Order in Dockets 97-0601, 97-0602, and 97-0516 (consol.) and expects further reductions of $10.5 million for a total overall carrier access reduction of $43.8 million.

Staff's Position

Staff believes AI's re-balancing proposal has numerous defects and recommends the Commission reject the proposal. First, Staff claims that AI is understating the amount of revenue collected from the provision of network access line services. Particularly, Staff asserts the understatement of revenue occurs from AI's estimate of revenues it receives from EUCL charge. As such, Staff concludes, even using AI's LFAM cost studies, AI's proposal cannot be justified.

Second, Staff contends that AI's LRSIC for network access line services show what the Company concedes are "substantially" increased compared to those the Company filed in its 2000 Aggregate Revenue Test filing. Based upon AI's new model, LRSIC for network access line services increased from 34% to 53%, depending on the

Access Area. Staff assets that without the above mentioned increases, revenues from network access line services would exceed LRSIC in all access areas.

Staff rejects AI's new model, the Loop Facility Analysis Model ("LFAM") and urges the Commission to do the same. Staff notes with skepticism that AI's new LFAM shows costs increasing dramatically while at the same time industry costs are declining. Staff points out that this Commission has never approved a cost study generated by, or costs derived from the LFAM model. Staff is not persuaded by AI's argument that its new model is able to identify and recover costs that prior models failed to identify and recover. Staff rejects AI's LFAM model for failing to conform with part 791 of the Code, specifically: the model uses futuristic network rather than planned network, use of incorrect fill factors, and its failure to reflect the demand for the entire service. Further Staff detected what it views as programming flaws. Staff contends that AI's interface of fiber vs. ~~Copper~~copper break length assumption ~~are~~is inaccurate. Additionally, material costs contained within the model fail to account for any merger related savings.

Because of~~an~~ uncertain demand effects, Staff, contends that AI's proposal is not revenue neutral. Staff claims that AI's proposal would actually result in revenue increases for AI. Staff's difficulty with the proposal is that AI proposes increases to services with relatively inelastic demands and decreases to services with relatively elastic demands.

Next Staff rejects AI's use of access charge reductions ordered in Dockets 97-0601, 97-0602, and 97-0516 (consol.) to offset rate increases. Staff claims that these specific rate reductions are not an appropriate way to offset any rate increases applicable to network access line charges. ~~Staff Initial Brief at 126.~~ While Staff acknowledges generally that certain price reductions could be made if network access line rates were below LRSIC, such reductions must come from within the Plan itself. Staff contends ~~that~~what AI seeks to do is to improperly offset price increases with price reductions ~~which~~that were required outside of the Plan.

As a general proposition, Staff does agree that to the extent that revenues generated from providing network access line revenues are below LRSIC, rate re-balancing in some form might be appropriate. Only to the extent that AI could prove that a rate is below LRSIC would Staff consider a corresponding rate increase.

Staff then seeks to rebut AI's argument relative to contribution for shared and common costs. Staff asserts that it is not necessary for every service to contribute toward shared and common services. Staff offers its own proposal should the Commission agree that residence network access line rates are below LRSIC. Staff suggests that there be a reduction in Band A usage rates. Staff states that its proposal would pass on benefits to nearly all customers as opposed to AI's rate reductions to optional, and in its view unnecessary services. Further, Staff notes its proposal will negate or diminish the effect of increase costs on those consumers who can least afford an increase.

Staff concludes however, that based upon the LRSIC used in AI's year 2000 Aggregate Revenue Test, revenues for residence network access lines exceed LRSIC in all access areas. Therefore, Staff surmises, AI's rate re-balancing proposal must be rejected.

DOD's Position

The DOD supports AI's rate re-balancing proposal. DOD states that the proposal will however create a net increase in revenue for AI. DOD contends that it is beneficial to align rates with costs as the telecommunication industry transitions from a monopoly market to a competitive environment. DOD argues that network access line rates have been under_priced relative to it costs. DOD/~~FEA~~ also contends that the AI proposal will reduce rates for certain services that have been priced above costs.

DOD proposes modifications to AI's rate re-balancing proposal. To address the concerns of Intervenors relative to issue of Universal Services, DOD/~~FEA~~ suggests that those customers would otherwise be eligible for lifeline services be exempt from the rate increase proposed by AI. Further, DOD/~~FEA~~ recommends that IXCs provide proof to the Commission that reductions in carrier access charges are flowed through to ratepayers. Next, DOD/~~FEA~~ proposes that the Commission direct AI to reduce all monthly network access line charges, both residence and business, by an amount that equates on a revenue basis to the reduction in access charges that were not previously passed through to consumers. Additional consumer protection is necessary DOD/~~FEA~~ argues, because historically, market forces have not lead to a flow through of rate reductions to consumers.

City/CUB's Position

CUB, AG, and County ultimately adopt the arguments made by City. City also urges the Commission to reject AI's rate re-balancing proposal. First, as a Universal Service policy consideration, AI's proposed increase may result in forcing ~~low income~~low-income customers to drop off the network. On balance, City claims that customers' overall bills will increase rather than remain neutral.

Like Staff, City is skeptical of AI's new LFAM model results given that AI had just a few months prior filed with the Commission its Annual Revenue Test report which indicated substantially reduced costs. City ~~addresses what it views as flaws of AI's LFAM model. First~~argued in its Initial Brief that the LFAM failed to use "Least Cost Currently Available" technology. ~~Next, City assets~~City also made arguments regarding other aspects of AI's cost studies. First, City asserts that AI improperly included "common" costs of a switch in the port cost. City charges that AI improperly double recovered the costs of installing the network interface device. The City ~~AI LFAM~~asserts that AI's LRSIC studies failed to address what the City calls a line mix assumption. What the City suggests is that AI take into consideration the different costs associated with the costs per line of installing a new switch versus the costs of adding lines to an existing switch. City asserts that AI's data shows they considered the higher costs per line for new switches disproportionately, which skews costs upward. City claims that AI's use of the "revenue ready" fee in the network access line LRSIC is improper as said fee ~~can~~could be attributable to several other services, not just network access lines. Further, City claims it is inappropriate to include the costs of receiving and processing payments for several services, as~~a~~ costs attributable to network access line rates. Like the revenue ready fee above, City asserts the cost for receiving and processing payments should at the very least be spread across LRSIC for several services. City also rejects AI's use of "Cost of Capital" in its ~~LFAM.~~LRSIC studies. Lastly, City contends that AI's ~~LFAM~~CAPCOST Model considers an inflated "net ~~investment."~~investment.

City also rejects AI's attempts to include additional costs to network access line LRSIC. City claims the addition of "spare capacity" and advertising costs artificially inflates network access line LRSIC. City argues that the Commission cost of service rules require that LRSIC include only "usable capacity" and not the additional spare capacity. Lastly, City asserts it is improper to assign 100% of advertising and related costs solely to network access lines.

City concludes that AI's rate re-balancing proposal should be rejected, as it is not justified on a cost basis or any purported policy reason offered by AI. Like Staff, City asserts the year 2000 Aggregate Revenue Test report filed on March 31, 2000, indicates that AI's rates are already in excess of costs. Similarly, City objects to AI's use of optional vertical services as an offset to an increase in network access line rate.

AT&T's Position

In response to Staff's proposal to offset an increase for network access line rate with a corresponding decrease in Band A usage rates, AT&T cautions the Commission not adopt any modification which would reduce rates simply to balance revenues rather than reduce rates based upon costs. Further, AT&T rejects AI's assertion that the Commission concluded in its Phase II Order that AI was entitled to revenue neutrality to compensate it for the reduction required in said order. Rather, AT&T asserts, the Commission concluded that AI was not entitled to revenue neutrality as a matter of right. However, AT&T acknowledges that the Commission would allow AI to seek out whatever mechanisms were available to it to attempt to recoup any lost access revenues. Finally, AT&T argues that should the Commission approve AI's re-balancing proposal, AI must implement its estimated additional $10.5 million in network access line reductions at the same time any authorized rate increase is to take effect.

AI's Response

AI responds to many of the concerns of Staff, City/GCI and DOD. Generally AI argues that its new LFAM model is an improvement over the model previously use. AI's asserts its new model results in cost studies which are more accurate than that performed for the 2000 Aggregate Revenue Test. With respect to the arguments of Staff, AI states that it has met its burden and shown that current network access line rates do not cover LRSICs. AI relies upon it updated costs model, the LFAM. AI states that it did not understates access line revenues. Also, AI amended its revenue analysis to take into ~~consideration Staff's~~ consideration Staff's concern over account demand changes. Lastly, AI again asserts that it perfectly acceptable within the Alternative Regulation Plan to offset a portion of the proposed network access line rate increases with the carrier access charge reduction required in Dockets 97-0601/97-0602. In response to Staff's alternative offset proposal, reduction of Band A rates, AI argues that based upon current usage, further reduction is Band A rates will cause costs for said service to increase above LRSIC.

In response to Staff's assertion that use of the LFAM resulted in increases in the LRSICs calculated for network access line service over the results of the LRSIC studies used to develop the Company's last Aggregate Revenue Test filing, the Company pointed out that the LFAM was improved significantly and was applied using more realistic input assumptions. As a result of these improvements, which were described in Mr. Palmer's testimony, AI contends the cost studies under review in this proceeding resulted in a more accurate estimate of the Company's network access line costs.

In response to Staff's assertion that the LFAM is not based on the existing network configuration as required by the Cost of Service Rule, the Company points to Palmer's testimony. It is the Company's position that Palmer described the manner in which the investment calculations performed by the LFAM reflect actual AI network configuration data, characteristics and engineering practices. The Company also responded to Staff witness Green's assertion that the LFAM may be too "forward-looking" by again citing to Palmer's testimony that the LFAM is based on current network configurations and locations and reflects only the demand for loops expected during the study period, in this case, 2001. Contrary to Staff's assertion, therefore, AI concludes the LFAM does not model a hypothetical, futuristic network. The Company further notes that Mr. Green's concerns about the LFAM were predicated on the fact that the LFAM, as applied by the Company in this case, utilized a breakpoint of 6,000 feet between copper and fiber cables in the loop, rather than a 12,000 feet breakpoint. The Company contends that the 6,000 feet breakpoint is consistent with appropriate engineering practices and principles and complies with the forward-looking cost requirement of the Rule. The Company further notes that changing the breakpoint to 12,000 feet (which is less economical than a 6,000 feet breakpoint) would result in an increase in the LRSICs for network access lines.

AI also disputes Staff's argument that the LFAM uses incorrect fill factors. AI suggests that the fill factors used in its cost studies for drop and feeder fiber cable are based on useable capacity and, therefore, comply with Section 791.20 of the Cost of Service Rule. The Company asserts that if the cost studies were run using Staff's assumptions regarding fill rates, the impact on the resulting LRSICs for network access line service would be de minimus.

In response to Staff's argument that the LFAM violated the Cost of Service Rule because of its "failure to reflect the demand for the entire service," the Company alleges that Staff misinterpreted Section 791.40 of the Cost of Service Rule, which requires only that all demand for service subject to a LRSIC study be included in this study. The Company further believes that its cable sizing and costing methodology does, in fact, comply with Section 791.40, even as interpreted by Staff.

In response to Staff's assertion that a consultant retained by Staff to review the LFAM had encountered a "problem" operating the model while attempting to test alternative fiber/copper breakpoint assumptions, the Company asserts that the problem encountered was a malfunction in the graphical user interface ("GUI"), not the LFAM itself. The Company also points to evidence presented by Mr. Palmer demonstrating that, when the correct base case result is used as a starting point, there are no anomalies in the results of running the LFAM using different scenarios regarding the copper/fiber breakpoint and other variables.

In response to Staff's suggestion that material costs contained within the LFAM failed to account for merger-related savings, the Company states that this argument assumes that there will, in fact, be a reduction in material costs resulting from the Ameritech/SBC merger. The Company claims there is no support for such an assumption. The material prices used in the LFAM reflect the vendor contracts in effect at the time the cost studies were undertaken, in compliance with Section 791.20(c) of the Cost of Service Rule, which require that costs be "based on the least cost technology currently available whose costs can be reasonably estimated based on available data." The Company also points out that there is no basis to conclude that all costs of materials used in provisioning loops will decrease under new post-merger contracts. Such contracts will likely contain some price decreases and some increases when compared to either SBC's or Ameritech's pre-merger contracts."

With respect to the arguments of City, AI states that its costs study is accurate and reliable and supports increasing access line rates. Additionally, AI asserts that other services may~~be~~ currently be priced above cost to make up for the shortfall ~~which~~that exists because network access line rates are priced below cost. Lastly, City's argument that basic residential services rates cannot be increased because of the moratorium against said increases imposed in the Order, must be rejected. AI asserts~~,~~ the moratorium was for a specific period of time, five years. Given that the ~~five year~~five-year period has elapsed, AI contends it may properly seek rate increases for residential services.

AI rejects DOD's proposal to exempt certain customers from its proposed rate increase. AI asserts that the simultaneous reductions of rates to other services will offset its proposed rate increase. Further, that because services associated with new service will be see rate reductions, AI opines that telecommunication services will become more economically accessible.

AI's Exceptions

In its Brief on Exceptions, AI noted that Section 13-518 of House Bill 2900 will require AIto offer certain flat rate local service packages to residential customers. According to AI, the required introduction of flat rate service represents a significant change in the Company's existing rate structure, which, in accordance with Commission policy, has reflected mandatory measured local service since the 1980s. The Company is in the process of developing rate packages designed to meet the requirements of Section 13-518. At this time, AI contends it is uncertain what impact Section 13-518 and the flat rate packages ultimately approved by the Commission will have on the Company's rate structure in general, and the rate rebalancing proposal in particular. Accordingly, until it has had an opportunity to fully assess that impact, the Company has determined that it would withdraw its rate-rebalancing proposal. The Company also took exception to the Proposed Order's statements regarding the LFAM on the grounds that such statements are unsupported by adequate findings and are contrary to the evidence. The Company argues that the Commission should, based on the evidence, modify the Proposed Order to approve the LFAM and the Company's LRSIC studies. At a minimum, the Company states, the Commission should eliminate the Proposed Order's criticisms of the LFAM are unnecessary in light of AI's decision to withdraw the rate re-rebalancing proposal.

Commission Analysis and Conclusion

As stated above, AI has withdrawn its rate rebalancing proposal. Staff and Intervenors suggest that the Commission make a finding as to whether the Company's proposed LFAM model is deficient, while AI urges the Commission to adopt its LFAM model or alternatively direct Staff to work with the Company to address and resolve specific concerns with AI's model. We conclude that it is inappropriate to make a finding on certain issues but not others, where a petitioner has requested that its petition be withdrawn. Accordingly, it is unnecessary for the Commission to address and resolve the contested issues regarding AI's rate rebalancing proposal and the results of costs studies presented in support of that proposal. We note that should AI decide at some time in the future to file a new rate rebalancing petition, it again will have the burden of proof, including demonstrating to this Commission that its cost study model, whatever study it may be, is compliant with our rules.

~~The Commission concludes that the rate re-balancing proposal of AI must be rejected in its entirety at this time. Despite AI's protestations to the contrary, Staff and City fully set forth several deficiencies with the LFAM. Particularly troubling is the LFAM's lack of compliance with part 791 of the Administrative Code. Also troubling is the apparent programming flaws detected by Staff and City. We note that City lists no less than seven deficiencies with AI's LFAM.~~

~~What is telling about the new model's reliability or lack thereof, is the significant change in costs resulting in the use of the LFAM model from the use of the 2000 Aggregate Revenue Test. Both tests were done within just a few months of one another. AI would have the Commission believe that it's model used in the 2000 Aggregate Revenue Test was so deficient that it failed to capture up to 1/3rd of the total actual costs for network access lines. To say the least, the Commission is skeptical of the LFAM's ability to find never before found costs. Further, the Commission rejects the LFAM model to the extent that it fails to comply with requirements of Part 791. Staff correctly points out that this Commission has never approved a cost study generated by, or costs derived from the LFAM model nor do we choose to today. Ultimately, AI has failed to meet is burden in convincing the Commission that its costs for network access lines are above LRSIC. For that reason, the Commission rejects AI's rate re-balancing proposal.~~

V. GOING FORWARD

A. The Existing Components of the Formula.

The alternative form of regulation ties rates for noncompetitive services to an index and, thereby supplants AI's typical rate case with a more streamlined process with which price changes can be approved. The process consists of an annual filing made by AI and requires subsequent approval by the Commission of the proposed price cap index, to be effective on July 1 of the year of the filing. Under the Plan the PCI must be recalculated once each year. The PCI can be generally described as: PCI = Inflation factor minus the "X" factor (4.3%) for a productivity offset, minus 0.25% for each missed service quality benchmark, +/- any Commission-approved "Z" (exogenous change) factor.

Terms used in the PCI are generally described as follows:

> ***Inflation Factor:*** inflation is represented by Gross Domestic Product Price Index, ("GDPPI") which measures economy wide inflation for all goods and services;
>
> ***X factor:*** the X factor represents the extent to which AI (or the telecommunication industry in general) experiences productivity growth which exceeds that of the overall economy (economy-wide productivity gains are already reflected in GDPPI) and any consumer dividend which the Commission may include;
>
> ***Z factor:*** the Z factor captures "Exogenous changes," which are externally driven costs or revenue changes which impact AI uniquely or disproportionately reflective to the overall economy; and

Service Quality Factor: the service quality factor established benchmarks for service and imposes penalties if service quality declines.

More precisely the PCI formula is as follows:

$PCI_t = PCI_{t-1}$ [1+ (% change in the GDPPI)/100-.043 +/- Z - Q]
where:

PCI_t	= price cap index for current year,
PCI_{t-1}	= price cap index for previous year,
GDPPI	= Gross Domestic Product Price Index,
Z	= exogenous change factor, and
Q	= quality of service component, which is negative.

Additionally, pursuant to the Plan, most of AI's noncompetitive services ~~have~~had been separated and placed into four distinct customer groups or service baskets. They are as follows: 1) Residential Basket, 2) Business Basket, 3) Carrier Access Basket and 4) Other Services Basket. The prices for the services within each of these baskets are allowed to fluctuate over time such that each basket's Actual Price Index ("API") never exceeds the PCI. The requirement that API for the baskets are less than PCI has placed the emphasis of AI's annual filings on the calculation of the PCI and the justification of each of its inputs.

Each basket's API is a reflection of the basket's average price once demand and any proposed tariff changes are properly accounted for. The API may change at any time during the year when price changes are made. (Order, Appendix A at 3). The API for an individual basket is calculated as follows:

$$API_t = API_{t-1} * \underset{i=1}{\overset{n}{S}} v_i \frac{P_i(t)}{P_i(t-1)}$$

where:

API_t	= actual price index for the current year,
API_{t-1}	= actual price index for the previous year,
i	= rate element i,
$P_i(t)$	= proposed price for the i_{th} element,
$P_i(t-1)$	= current price for i_{th} element, and
v_i	= revenue weight for i_{th} element.

The Commission has established a very specific set of filing requirements which the product thereof the Commission can use to determine whether it should approve AI's annual rate filings with or without modifications. In its Order, the Commission stated:

Illinois Bell shall be required to make an annual rate filing no later than April 1 of each year of the plan after 1994. At that time, Illinois Bell shall provide the following information:

(a) the price cap index for the following 12-month period (July to June), with supporting data showing the GDPPI for the previous calendar year and the percent GDPPI change for that 12-month period;

(b) the actual price index ("API") for each service basket, including the effects of proposed rate changes under the price cap index for the following 12-month period (July to June) and adjustments for new services added, existing services withdrawn, and services reclassified as competitive or noncompetitive;

(c) tariff pages to reflect revised rates;

(d) supporting documentation demonstrating that any proposed rate changes are consistent with the requirements of the price index mechanism;

(e) a demonstration that Illinois Bell would be in compliance with Sections 13-507 and 13-505.1 of the Act if the proposed rate changes went into effect;

(f) an identification of any changes to the GDPPI weights and an assessment of the effects of such changes, and any necessary modifications to the PCI;

(g) the current data showing the calculation of Z for the previous calendar year, with the events causing Z to change identified and described;

(h) the current data showing the calculation of Q for the previous calendar year, with the events causing Q to change identified and described.

(Order at 92). The Order further provided that "Staff and all of the interested parties will have an opportunity to file written comments in response to each annual filing and the Company will have an opportunity to file reply comments." (Id. at 93).

B. Proposed Modifications to the Price Cap Index.

1. Measure of Inflation

One component of the PCI is the Inflation factor, which is derived by using GDPPI. The GDPPI is used to measure the annual economy wide inflationary change that has occurred in a given time period. GDPPI is published by the Bureau of Economic Analysis, U.S. Department of Commerce ("BEA"). At the time of it's Order, a fixed weight version of GDPPI was the accepted and published output measure of inflation for the economy.

Since the entry of the Order, a "chain weighted" GDPPI has replaced the fixed weight GDPPI as the most commonly used inflation measure in the economy. Staff, as well as most every party, acknowledges that the methodology used to compute the chain weighted GDPPI is closer to the methodology used to compute AI's input prices. The methodologies used to compute the chain weighted GDPPI and AI's input prices allow for changes in the composition of output or input, whereas the methodology used compute fixed weight GDPPI does not. The parties agree that it is more proper to use the chained weighted GDPPI in the future as the inflation index.

The Commission concludes the use of a chain weighted GDPPI shall be substituted for the fixed-weight version in the price index on a going forward basis.

2. X Factor

Under the Plan, the "X" Factor in the price cap formula consisted of three elements: productivity differential, input price differential, and consumer dividend. The productivity differential measures the difference between telecommunications total factor productivity gains and overall economy total factor productivity gains. The input price differential measures the difference between telecommunications input prices and economy wide input prices; The third element of the X factor, the consumer dividend, is a judgmental factor imposed by the Commission based upon its expectations regarding gains that arise from technological and or regulatory change that the Commission anticipates. Under the Plan, the productivity differential was set at 1.3%, the input price differential was set at 2.0% and the consumer dividend was set at 1.0%. (Order at 38.)

Under the Plan the productivity and input price differentials were based upon AI's productivity and input price performance versus the economy as a whole, as opposed to industry productivity and input price data. Industry productivity and input price data was not yet available. Staff proposes that both productivity and input price differential be based on industry rather than AI specific data. AI~~,~~ concurs.

a. Productivity Differential & Input Price Differential

AI and Staff's Position

AI sponsored the testimony of Mark E. Meitzen in support of its proposed productivity differential. Dr. Meitzen provided an analysis of the local exchange industry's total factor productivity ("TFP"). Dr. Meitzen's analysis used the Total Factor Productivity Review Plan ("TFPRP"), which was developed by the United States Telecom Association ("USTA"). Dr. Meitzen concluded that 3.3% is appropriate for the productivity differential and input price differential. Similarly, Staff relies upon the USTA productivity study and also recommends adopting the 3.3% figure for productivity differential and input price differential.~~(Staff Initial Brief at 36.)~~

AI noted that industry-wide TFP and input price performance data have become available since the Commission's 1994 Order. On a going forward basis, Staff and AI proposed~~d~~ that the X factor be based on industry performance, not on AI's own historical performance~~, on a going forward basis~~. AI stated that, as a matter of price regulation theory, the productivity target should not be directly influenced by the performance of ~~the~~a particular firm subject to the price index. According to ~~AI,~~the Company, this approach better replicates what occurs in competitive markets, where pricing is related to industry productivity and input price averages. AI ~~pointed~~points out that GCI/City also supported the use of a productivity factor based on industry-wide performance.

AI therefore proposes a productivity differential and input differential of 3.3%, with no consumer dividend for an overall X factor of 3.3%. Staff recommends a productivity differential and input differential of 3.3% plus a 1% consumer dividend for an overall X factor of 4.3%.

GCI/City's Position

Upon a review of the initial briefs of City, AG, County, and CUB, it appears as though they have taken a consistent view with respect to the issue of the X factor. Each of the above ~~intevenors~~Intervenors filed separate briefs relative to the issue of the X factor but filed a joint reply brief on this, as well as other issues. ~~City/GCI~~City andGCI maintain that an overall X factor 4.3 is too low. City and GCI recommend an overall X factor of 6.5% which would in effect incorporate a productivity differential, input price differential, and a consumer dividend. GCI bases it's recommendation of a 6.5-% X factor on the proposal made by SBC, Bell Atlantic, Bell South, and GTE in the CALLS Proposal.

CUB acknowledges that one of the most important elements of a price cap formula is the establishment of an appropriate productivity offset. In a competitive market companies have an incentive to improve productivity and cut costs in order to increase profits. CUB suggests that in theory competition will cause improved productivity and resulting lower prices to customers. The goal of a productivity offset in a price cap formula, CUB asserts, is to reflect the characteristics of a competitive market.

CUB is critical of AI and Staff's reliance upon AI's Total Factor Productivity ("TFP") study. First CUB contends it is no longer appropriate to use company specific data as a basis for calculating TFP. CUB notes that at the federal level, in the FCC price cap formula, industry results are used rather than those of a specific company. Secondly, the X factor under the current plan was insufficient to assure that consumers realized their share of efficiency gains. CUB makes this assertion because of what it deems to be AI's staggering earning levels. Further, CUB is critical of relying upon the USTA TFP. CUB states that the FCC has never used the USTA study for purposes of creating an X factor. CUB witness Dr. Selwyn finds fault in the USTA TFP study for using deflated revenues to measure local output. Additionally CUB argues the USTA study's use of economy wide cost of capital data as a proxy for local exchange carrier costs of capital essentially creates a cross subsidy flow from noncompetitive services.

~~AI and Staff's Response~~

~~Both AI and Staff responded to CUB criticisms of AI's TFP. AI witnessMeitzen, and Staff witness Staranczak explained that the deflated revenue approach is a well known and widely accepted method for measuring output. Meitzen notes that the Bureau of Labor Statistics uses the deflated revenue approach to construct its output index for the telecommunications industry. Meitzen also points out that the deflated revenue approach was used in the original alternative regulation plan.~~

City, in its ~~initial brief,~~Initial Brief, incorporates the position of AG. AG ultimately concludes that the goal of the X factor is to maintain AI's rates and earnings at reasonable levels. AG does not criticize, as CUG does, AI and Staff's reliance upon AI's TFP as a predicate to rejecting the 4.3% X factor. AG does however reject the 4.3% X factor as being too low. Under the current plan AG contends the 4.3% X factor has failed to curb what it deems as ~~AI's~~ excessive earnings by AI. Like CUB, City and AG recommend the use of a 6.5% X factor.

County also ~~calls for the adoption of a~~requests adopting the 6.5% X factor as used by the FCC for intrastate services. Like AG and City, County does not specifically criticize AI's TFP study but does reach a similar conclusion that the current 4.3% X factor is inadequate. County asserts that had there been in place an X factor of 11.06% from the inception of the alternative regulation plan, AI on a total company basis would have achieved an annual return of 11.36%. County is not advocating the use of an 11.06% productivity factor but presents this information to highlight how reasonable a 6.5% X factor is.

In order to ensure that AI's noncompetitive rates are established at just and reasonable levels, City/GCI recommend the adoption of a 6.5% X factor. The 6.5% figure is taken from the FCC price cap order, which adopted the "CALLS" settlement proposal, whereby interstate prices are reduced by a 6.5% offset against inflation. Said 6.5% X factor includes a .5% consumer dividend. City/GCI rely upon the testimony of Dr. Selwyn. Dr. Selwyn testified that the 6.5% X factor would be appropriate because it is based on unseparated total company productivity results; it is based on ~~FCC Staff's~~FCC's Staff analysis of local exchange company productivity and input price differential for the 1985-1995 time period; the FCC's Staff analysis was based on physical output measures (first local calls and later minutes of use); and it was accepted by the BOC's as part of the overall CALLS Proposal.

City/CUB acknowledge that the FCC declined to call the 6.5% X factor as used in the CALLS Proposal, a "productivity number" but instead the FCC chose to call it a "transitional mechanism that operates to reduce rates." No matter what the label, City/CUB contend, the FCC X factor and the Illinois X factor serve the same purpose, that is to mimic competitive forces and maintain AI's rates and earning at reasonable levels. Despite the FCC's reluctance to call its X factor a productivity number, City/CUB urges the adoption of the 6.5% X factor as it serves the same purpose, no mater what the label.

AI and Staff's Response

Both AI and Staff responded to CUB criticisms of AI's TFP. AI witness Dr. Meitzen, and Staff witness Staranczak explained that the deflated revenue approach is a well-known and widely accepted method for measuring output. Dr. Meitzen notes that the Bureau of Labor Statistics uses the deflated revenue approach to construct its output index for the telecommunications industry. Dr. Meitzen also points out that the deflated revenue approach was used in the original alternative regulation plan.

AI opposes the adoption of the FCC's 6.5% X factor in this proceeding. AI opines that the FCC's X factor is not a valid productivity measure. AI presented the testimony of Dr. Meitzen in support of its opposition to the FCC X factor. Dr. Meitzen testified that the FCC X factor was designed not as a productivity measure but a transitional mechanism, one that was imposed to reduce interstate carrier access rates. ~~Ultimately~~, Dr. Meitzen ~~concluded that the transitional mechanism would serve only to transform the Illinois X factor into a mechanism that serves only to reduce rates at a certain pace while at the same time it would not be linked to a specific measure of productivity. (AI Ex. 2.2, at 19.)~~ Dr. Meitzen concluded that the CALLS proposal served to transform the FCC's X-Factor from a productivity factor into a transitional mechanism that operates to reduce interstate rates at a certain pace and would not be linked to a specific measure of productivity.

AI numerated other flaws with the FCC X factor. AI claims that the FCC staff used outdated data and improperly used only a single physical measure of local output. Further, the FCC's output specification did not match the sources of revenue growth. Also, AI argues the use of a residual earnings method to estimate capital costs by the FCC was improper.

Similarly, Staff contends that the study used by the FCC to arrive at its 6.5% X factor is flawed. Staff argues that it produces inaccurate output growth, input price growth and productivity growth estimates. Specifically Staff cites the following flaws with the FCC study: 1) proxying local output by local calls only, when in fact local output consists of many services including lines and vertical services which grow at different rates than ~~minutes~~ calls, 2) excluding miscellaneous revenues from the output measure, and 3) inappropriately computing capital input prices based on realized rather than expected rates of return. ~~Staff Ex. 16.0 at 10-16.~~ Like AI, Staff notes that the FCC no longer characterizes its X factor as a productivity offset but considers it a policy instrument. ~~Staff Reply Brief citing Ameritech Ex. 2.2 at 19 (Sixth Report and Order)~~ Staff urges the rejection of City/GCI's 6.5% X factor as methodologically flawed and greatly in excess of AI historical productivity growth.

b. Consumer Dividend

AI and Staff have divergent views with respect to the inclusion of a consumer dividend. Staff supports maintaining a 1% Consumer dividend in the Price Cap Formula. AI urges the Commission not to extend a consumer dividend for another term of the Plan. AI suggests that the consumer dividend was made apart of the Plan "to ensure that customers received 100% of the benefits of the Company's first productivity gains under the plan." ~~(AI Brief at 40.)~~ However, AI contends that the consumer dividend actually had the effect of flowing through all of the productivity gains that AI achieved during the first five years of the plan and an additional .8 % that AI did not achieve. AI argues that the Commission did not have the benefit of real data when it imposed a 1% consumer dividend in the initial Plan. Now, however, AI concludes, based upon actual experience, the imposition of a consumer dividend is unwarranted on a going forward basis.

Staff urges the Commission to extend the consumer dividend and recommends such dividend be 1%. Staff contends that ~~in~~ an inclusion of a consumer dividend fulfills the requirement under Section 13-506.1 (b)(5) of the Act wherein an alternative regulation plan must specifically identify how ratepayers will benefit from efficiency gains, costs savings resulting from regulatory change and improvements in productivity due to technological change. Staff takes issue with AI's statement that the consumer dividend had the effect of flowing through all the productivity gains made by AI. Staff contends that on a company wide basis, AI passed along less than half of its productivity gains during the initial five years of the plan. Further, Staff notes, AI passed along no productivity gains of its competitive services. Staff suggests that AI's real problem with the consumer dividend is that prices of non-competitive services fell by more than overall company productivity gains. ~~Staff Reply Brief at 16.~~

City/GCI recommend that a consumer dividend be included in the PCI formula should the Commission rejects its suggested X factor. A consumer dividend acts as an incentive on the incumbent carrier to improve its overall efficiency. It also acts as a form of consumer protection so as to allow a consumer to receive at least some specific benefits of price cap regulation. Further, City/GCI argue that AI's position that a consumer dividend should be eliminated because it achieved less cost savings than the price cap flowed back to consumers must be rejected as refuted by the record which City/GCI contend shows AI's earnings skyrocketed under the plan in spite of price index rate reductions.

Commission Analysis and Conclusions

The Commission further concludes that the X factor should be set at 4.3% (inclusive of productivity differential, input price differential, and consumer dividend) on a going forward basis. The calculation of the LEC industry's productivity and input price performance as performed by AI witness Dr. Meitzen, is appropriate for use in the price index. Additionally, the deflated revenue approach to measure output is also appropriate for use herein. The deflated revenue approach is widely accepted, including its prior use by this Commission. We see no reason to deviate from the use of the deflated revenue approach on a going forward basis. City/GCI contentions of methodological shortcomings with TFP, to the contrary are not persuasive. We reject the use of 6.5% as the productivity factor as proposed by City/GCI. We find it very telling that even the FCC has not adopted 6.5% X factor as a productivity factor but rather prefers to call it a transitional mechanism or a policy instrument. There remain serious methodological issues associated with the FCC's Staff's prior ~~analyses which~~ analyses, which forms the basis for a 6.5% X factor.

An alternative regulation plan, at a minimum, must satisfy several criteria as detailed in 13-506.1(b) of the Act. The Commission may approve a plan or a modified plan only after it finds that the plan satisfies those minimum requirements as stated herein above. As such, AI's alternative regulation plan or any extension thereof must identify "how ratepayers will benefit from any efficiency gains, costs savings arising out of the regulatory change, and improvement in productivity due to technological change." 13-506.1(b)(5). Just as the Commission was persuaded in 1994, we are again persuaded that an additional component to the price regulation formula is the most direct and appropriate way to achieve the goal of identifying how ratepayers will benefit from the extension or modification of AI's plan. We agree with Staff and City/GCI and conclude that a 1% consumer dividend should be included within the X factor to assure that ratepayers will benefit from any efficiency gains, costs savings arising out of the regulatory change, and improvement in productivity due to technological change.

AI in its Briefs seems to suggest that under the Plan, ratepayers were only to receive a consumer dividend for the first term of the plan. The implication therefore is that once the original term of the plan expired, so to would the consumer dividend. We reject this implication. Ratepayers are to receive the first cut from any improvements which arise from technological and regulatory change under the original term of the Plan and just as importantly any modification or extension thereof. Given our position relative to earnings sharing, the use of a consumer dividend is vital for this modified plan to maintain compliance with the Act.

3. (Z) Factor

The Z factor accounts for any impact associated with changes made to the Federal Communications Commission's ("FCC") rules, and/or with some other change which is quantifiable and outside AI's control, and has not been picked up in the economy wide inflation factor. We have previously held that exogenous factor treatment should be allowed only for costs: 1) which are truly outside the Company's control; 2) which can not be picked-up on in the economy-wide inflation factor, to avoid double-counting; 3) which are verifiable and quantifiable, to ensure that the effect of the exogenous event can be accurately determined without protracted, controversial regulatory involvement; and 4) the changes must exceed $3 million.

AI's Position

AI proposes that the Z factor continue to be a component of the price cap index mechanism. AI does however propose a change as to when such a Z factor change can take place. AI also requests that on a going forward basis, the Commission expressly recognize the exogenous treatment of Commission mandated rate reductions.

Under the current plan an exogenous change, if approved by the Commission, is inserted into the formula and is allowed to take place at the next annual filing. AI proposes that exogenous treatment for rate reductions should be allowed to take place immediately, without waiting for the next annual filing under the Plan. ~~(AI Initial Brief at 41.)~~

Staff's Position

Staff also proposes that the Z factor continue to be a component of the price cap index mechanism. Staff acknowledges that the Commission would want flexibility built into the price cap plan to deal with issues that cannot be satisfactorily dealt with elsewhere and the Z factor is a place where such discretion could be exercised. ~~(Staff Initial Brief at 19.)~~ On a going forward basis, Staff proposes that AI must file for exogenous change treatment within 30 days of such revenue reduction with the specific rates it wishes to change. Staff would then review the proposed rate changes. Final rate changes necessary for revenue recovery would then be implemented no later than 60 days after the initial AI filing. Additionally, Staff proposes that the Commission reserve the ability to delay rate changes until the annual price cap filing, as well as deny revenue neutrality. Further, Staff states that the Z factor is not intended nor should it be used as an earnings management tool.

GCI/City's Position

City/GCI contend that the exogenous change factor should remain unchanged. City/GCI reject AI's proposal of extending exogenous change factor treatment to

Commission mandated rate changes. City/CUB argue that to allow automatic offsets for all Commission mandated rate changes would circumvent the Commission's discretion to determine whether the price regulation formula is just and reasonable absent the offset. City/GCI contend that the Z factor is based on the concept of revenue neutrality. To allow exogenous treatment for Commission mandated rate reductions, in City/GCI opinion, is inconsistent with revenue neutrality and price cap regulation. Further City/GCI argue, that under the AI proposed change, AI would receive more favorable treatment under price cap regulation than it would have received under rate of return regulation. Under rate of return regulation, rate changes are only allowed upon a showing that said change is necessary to maintain just and reasonable rates.

Next, City/GCI reject AI's proposal based upon its perception that such a proposal would do a way with Commission oversight of Z factor treatment. City/GCI also rejects Staff's ~~proposal which~~ proposal, which would allow Z factor changes to be implemented within 60 days of AI's filing. City/GCI claim that 60 days is inadequate to determine the revenue effect of a rate change because to the lack of reliable demand data. City/GCI ~~is~~ are also concerned that any Commission ordered rate reduction could result in a non-competitive services rate increase. Lastly City/CUB argue that one of the intended benefits of alternative regulation was to decrease regulatory burden. A single annual filing was intended to accomplish reduced regulatory burden. The Z factor proposals suggested by AI and by Staff serve to increase regulatory burdens by creating a new category of cases which Staff and other interested parties would have to examine, and examine on an expedited basis.

AT&T's Position

AT&T also opposes AI's request that the Commission expressly recognize that exogenous treatment of Commission mandated rate reductions are appropriate under the Plan. Should the Commission adopt AI's proposal, AT&T envisions a situation wherein AI would be entitled to exogenous treatment where the Commission mandated a rate reduction as result of a Commission determination that AI's rates were unjust and unreasonable. AT&T also opposes AI's proposal for immediate reductions.

AI's and Staff's Response

AI responds that once the Commission determines the going-forward price index in this proceeding, AI's obligation is to adjust its rates by the amount required by that index, not the index plus whatever other service-specific rate reductions the Commission may order. Denial of exogenous change treatment in those circumstances would unilaterally increase the X factor and such a result would be improper. The Company further states that it would not be reasonable to require it to use the ratemaking provisions of Article IX of the PUA or ask to rescind the plan just to remain whole under the index, as GCI/City proposed. The Company also states that, contrary to GCI/City's arguments, there is nothing uniquely difficult about determining the revenue effects of carrier access charge rate reductions on a demand-adjusted basis.

Staff also opposes GCI/City's proposal as an attempt to use the exogenous change factor as a mechanism for managing earnings. Staff states that the Commission designed the "Z" factor to account for exogenous changes, not as a device to manage AI's earnings under alternative regulation, and that it is improper to use it as such. Finally, Staff argues that it was immaterial whether it is complicated, or straightforward, to estimate revenue impacts from rate changes. Staff states that AI should be permitted to recover revenue lost from Commission mandated actions.

Commission Analysis and Conclusion

The Commission concludes that the Z factor continues to be a necessary component of the price cap index formula. The Commission had found in the ~~alternative~~ Alternative ~~regulation~~ Regulation ~~order~~ Order that an exogenous change factor is necessary because a price cap formula is an over simplification of a complex public policy. Order at 61. The Commission recognized then, as it does now, that the formula, without a Z factor cannot always reflect changing circumstances and balance competing interests fairly. However, on a going forward basis, clarification of the Z factor is appropriate. ~~However, on a going forward basis, clarification of the Z factor is appropriate. The Commission is persuaded by Staff's proposal that requires AI to make a exogenous treatment filing within 30 days of the exogenous event which it deems triggers the need for a rate change, together with the specific rates it wishes to change.~~

~~Further, an~~ An exogenous event may include a Commission mandated rate reduction. In the alternative regulation order the Commission recognized that a Z factor is necessary to allow for ~~changes which~~ changes, which truly are outside of AI's control. Order at 62. To automatically prohibit exogenous treatment for Commission mandated rate reductions is arbitrary and inconsistent with the theory behind providing for a Z factor. If AI claims an event has occurred which it feels requires exogenous treatment, AI must satisfy the four criteria as set out in the Order at 62, regardless of whether such an event was a result of a Commission mandated rate reduction or otherwise.

In all other respects the Z factor shall remain as originally ordered, including the actual application of a Commission approved exogenous event on an annual basis. The Commission will continue to retain the oversight it has experienced over the initial term of the Plan and AI, Staff, and interested parties will not be subjected to the additional regulatory burden of a new category of cases. As AI recognizes, and the Commission agrees, the exogenous change factor under the initial term of the Plan has operated as the Commission expected.